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DEPARTMENT OF AUDITOR-CONTROLLER

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July 25, 2007

TO: Supervisor Zev Yaroslavsky, Chairman
Supervisor Gloria Molina
Supervisor Yvonne B. Burke
Supervisor Don Knabe
Supervisor Michael D. Antonovich

FROM: J. Tyler McCauley
Auditor-Controller

SUBJECT: **FISCAL REVIEW OF ARROWHEAD EMANCIPATION PROGRAM - A GROUP HOME FOSTER CARE CONTRACTOR**

Attached is our report on Arrowhead Emancipation Program's (AEP or Agency) fiscal operations from January 1, 2004 through December 31, 2004. The Department of Children and Family Services (DCFS) contracted with AEP to care for foster children placed in the Agency's care. AEP is located in the Fifth Supervisorial District.

AEP was licensed to operate five group homes (GHs), each with a resident capacity of six children, during 2004. One of the five group homes was closed in June 2004 because the Agency could not obtain a new lease for the site. AEP's GH contract with the County expired in October 2005, and DCFS has indicated that all County placed children were removed from AEP's facilities. Under the contract, DCFS paid AEP $4,858 a month for each child, for a total of $1,355,169 during 2004. In addition, from January to April 2004, DCFS paid AEP $18,617 to operate an Emergency Shelter Program.

Scope

Our review was intended to determine whether AEP complied with its contract terms and appropriately accounted for and spent foster care funds on allowable and reasonable expenditures. We also evaluated the Agency's accounting records, internal controls and compliance with applicable federal, State and County fiscal guidelines governing the foster care funds.

Summary of Findings

We identified $170,831 in questioned costs and $1,235 in overpayments from DCFS. In addition, we noted that AEP needed to strengthen its internal controls over its accounting procedures, disbursements, payroll and bank reconciliations.

AEP's audited financial statements for calendar years 2002 and 2003 indicated substantial losses. The auditor's opinion for both years included a "going concern" qualification, questioning AEP's on-going financial viability. AEP's internal records for 2004 showed that the Agency was continuing to operate at a loss. As noted earlier, the Agency's contract with the County expired in October 2005 and was not renewed. Subsequently, my Office of County Investigations (OCI) investigated allegations of questionable/fraudulent transactions, substantiated a number of these allegations and recommended that DCFS initiate debarment proceedings against AEP. DCFS management has advised us that they have not decided whether to debar AEP.

We have recommended that DCFS resolve the questioned costs and, to the extent possible, pursue the collection of the disallowed amounts. In addition, DCFS needs to ensure that, if the Agency is not debarred and DCFS contracts with AEP in the future, AEP management takes action to address the recommendations in this report and monitor to ensure that the actions taken result in permanent changes. DCFS should also consider the Agency's financial condition and the impact that may have on any children placed in the Agency's care.

Review of Report

AEP management declined to meet with us to review this report. If the Agency submits a written response to DCFS, DCFS will incorporate the Agency's response into a Fiscal Corrective Action Plan that will be submitted directly to the Audit Committee. We thank AEP's management and staff for their cooperation during our review.

Please call if you have any questions, or your staff may contact Jim Schneiderman at (626) 293-1101.

JTM:MMO:JLS:MM

Attachment

c: William T Fujioka, Chief Executive Officer
Department of Children and Family Services
Patricia S. Ploehn, Director
Susan Kerr, Chief Deputy Director
Arrowhead Emancipation Program
Irma Reed, Executive Director
Board of Directors
California Department of Social Services
Cora Dixon, Bureau Chief, Foster Care Audit Bureau
Sheliah Dupuy, Bureau Chief, Foster Care Rates Bureau
Public Information Office
Audit Committee
Commission for Children and Families

ARROWHEAD EMANCIPATION PROGRAM
FISCAL REVIEW

REVIEW OF EXPENDITURES/REVENUES

We identified $170,831 in questioned costs and $1,235 in overpayments. Details of these costs/revenues are discussed below.

Applicable Regulations and Guidelines

AEP is required to operate its GHs in accordance with the following federal, State and County regulations and guidelines:

- GH Contract, including Exhibit I, Auditor-Controller Contract Accounting and Administration Handbook (A-C Handbook)
- Federal Office of Management and Budget Circular A-122, Cost Principles for Non-Profit Organizations (Circular)
- California Department of Social Services Manual of Policies and Procedures (CDSS MPP)
- California Code of Regulations, Title 22 (Title 22)

Unallowable Costs

We identified $82,814 in unallowable expenses that were charged to the GH program:

- $63,524 in penalties and interest, consisting of $60,479 in federal tax penalties and interest; $1,228 in State tax penalties and interest; $1,457 in non-sufficient fund fees, and $360 in late payment fees for medical insurance, telephone bills, and refuse services. Sections 16 and 23 of Attachment B of Circular A-122 indicate that fines, penalties, and interest payments are unallowable costs.
- $9,116 for interest paid on borrowed capital. Circular Section 23.a.1 states that interest on borrowed capital is unallowable.
- $4,750 in excess lease payments for an Agency property where the lease payments exceeded 12% of the property's fair market value (FMV). CDSS MPP 11-402.828 states that shelter costs shall not exceed 12% of the FMV of owned, leased, or rented buildings used for group home programs and activities.
- $3,706 in payments for the Executive Director's personal telephone, pool service and refuse service. Section 20 of Attachment B of the Circular states that costs of

housing, housing allowances and personal living expenses for the organization's officers are unallowable.

- $939 in payments for Agency fundraising activities. The A-C Handbook states that fundraising activities are not allowable under any circumstances.

- $425 in utility payments for a property that was not part of the GH program. Section 8.2 of the Agency's contract with the County state that funds can only be used for the care of foster children.

- $354 payment for repairs to the Program Director's personal vehicle. A-C Handbook Section 1.3 states that only those expenditures that are necessary, proper and reasonable to carry out the purposes and activities of the Program are allowable.

Unsupported/Inadequately Supported Costs

The A-C Handbook states that all revenues and expenditures shall be supported by original vouchers, invoices, receipts, timecards, travel logs or other documentation, and that unsupported expenditures will be disallowed upon audit.

We identified $88,017 in group home expenditures that were either unsupported, or inadequately supported.

- $51,261 in payments for gasoline purchases, car repairs, vehicle allowances, and vehicle leases or purchase payments. AEP did not maintain mileage records or other documentation for some vehicles to show whether the vehicles were used for group home or personal purposes. A-C Handbook Section A.3.2 requires agencies to maintain vehicle mileage logs showing the dates, destination and headquarters, purpose of trip and mileage.

- $20,025, including $19,025 in inadequately supported payments to four independent contractors for accounting services, maintenance, tax preparation, and training; and $1,000 in unsupported payments to two other independent contractors for maintenance.

- $16,731 in inadequately supported and unsupported employee reimbursements for items such as allowances, supplies, maintenance, activities, meals, rent and a stove.

Recommendations

DCFS management:

1. **Resolve the $170,831 in unallowable and unsupported/inadequately supported costs and, to the extent possible, pursue the collection of any disallowed amounts.**

If DCFS considers contracting with AEP in the future, AEP management:

2. **Ensure that foster care funds are used only for necessary, allowable and reasonable expenditures to carry out the purpose and activities of the Group Home.**

3. **Ensure taxes are paid timely to comply with the A-C Handbook requirements.**

4. **Consistently maintain adequate supporting documentation for all foster care expenditures, including original itemized receipts/invoices, mileage logs and contracts with all independent contractors.**

OVERPAYMENTS BY DCFS

We reviewed the payment records for fifteen group home children, and noted four with payment discrepancies from DCFS, with a net overpayment of $1,235. DCFS should work with AEP management to validate the overpayment and, to the extent possible, collect amounts overpaid. If DCFS contracts with AEP in the future, AEP management should ensure that any future payment discrepancies are immediately reported to DCFS and any excess amounts are repaid promptly.

Recommendations

DCFS management:

5. **Work with AEP management to validate the $1,235 in net overpayments and, to the extent possible, initiate action to collect the overpayment.**

If DCFS considers contracting with AEP in the future, AEP management:

6. **Ensure that any future payment discrepancies are immediately reported and repaid to DCFS.**

DELINQUENT PAYROLL TAX PAYMENTS

After the completion of our audit, AEP paid $317,831 to the Internal Revenue Service for delinquent federal payroll taxes dating back to September 2001, including $119,965 in penalties and interest. As noted earlier, penalties and interest are unallowable uses of foster care funds, and DCFS should recover those funds. Funds used to pay penalties and interest should be recovered as part of the unallowable costs discussed earlier.

In addition, using current period GH funds to pay non-current payroll taxes is an unallowable use of foster care funds. DCFS should determine the source of the funds AEP used to pay the delinquent federal payroll taxes and, if the taxes were paid with 2004 foster care funds, DCFS should pursue collection of those funds.

Recommendation

7. **DCFS determine the source of funds used to pay the delinquent federal payroll taxes, and, if the taxes were paid with 2004 foster care funds, DCFS pursue collection of those funds.**

FINANCIAL VIABILITY OF AEP

AEP's 2002 and 2003 audited financial statements indicated that the Agency was operating at a loss, and that this raised substantial doubt about AEP's ability to continue as a going concern. AEP's internal records for 2004 also showed a loss.

DCFS advised us that AEP's agreement with the County expired in October 2005, and was not renewed based on the operating losses and other issues. DCFS advised us that all the County-placed children were removed from AEP facilities.

As indicated earlier, DCFS is deciding whether or not to debar AEP. If the Department decides not to proceed with debarment and AEP expresses an interest in contracting with the County for group home services in the future, DCFS will need to carefully review AEP's financial condition and require AEP to provide a plan outlining how it will provide a high quality level of care, while addressing the Agency's financial difficulties.

Recommendation

8. **If AEP expresses an interest in contracting with the County in the future, DCFS carefully review AEP's financial condition and require AEP to provide a plan outlining how it will provide a high quality level of care, while addressing the Agency's financial difficulties.**

CONTRACT COMPLIANCE AND INTERNAL CONTROLS

We noted several contract compliance issues and internal control weaknesses. If DCFS contracts with EAP in the future, DCFS will need to ensure that AEP management takes action to address each of the internal control recommendations in this report. DCFS should also monitor AEP to ensure that these actions result in permanent changes.

Accounting Procedures

We noted the following weaknesses in the Agency's accounting procedures:

- AEP's financial records as of December 31, 2004 showed a $337,029 liability for loans payable to the Executive Director. The Agency was unable to provide any documentation to substantiate $192,636 of the liability. If AEP cannot substantiate the amount of the loan, the liability should be eliminated.

- AEP did not record a liability for the six vehicles it leased/purchased in 2003. As a result, the Agency's total liabilities are understated on its December 31, 2004 balance sheet.

- AEP does not maintain a fixed asset listing. A-C Handbook Section 4.2 requires that agencies maintain a current listing of fixed assets, including the item description, serial number, date of purchase, acquisition cost and sources of funding.

Recommendations

If DCFS considers contracting with AEP in the future, AEP management:

9. **Reduce the amount owed to the Executive Director to the extent the Agency cannot substantiate the amount of the loan.**

10. **Revise its December 31, 2004 balance sheet to include a liability for the six vehicles it leased/purchased in 2003.**

11. **Maintain a fixed asset listing in compliance with the A-C Handbook.**

Disbursement Procedures

AEP did not mark 47 of 58 (81%) invoices/receipts reviewed as "Paid", nor did they cross reference the invoices/receipts to the cancelled checks to prevent re-use. To prevent duplicate payments and to link supporting documents to the corresponding cancelled checks, all invoices should be marked "Paid" and referenced to cancelled checks.

Recommendation

12. **If DCFS considers contracting with AEP in the future, AEP management ensure all vendor invoices and receipts are consistently cancelled and referenced to cancelled checks.**

Payroll Records

The A-C Handbook requires that supporting documentation be maintained for all program expenditures, including salary rates. We reviewed fifteen employee personnel folders, and noted that nine did not contain the employees' current authorized salary rates. AEP needs to ensure that employee pay rates are consistently documented in the employees' personnel files.

In addition, we noted that four employees of the agency were overpaid by a total of $396. The overpayments were caused by the use of incorrect overtime rates, miscalculation of overtime/regular hours, and paying an employee time and a half, instead of straight time, for holiday time or sick leave.

Recommendations

If DCFS considers contracting with AEP in the future, AEP management:

13. **Ensure personnel files contain current authorized salary amounts or hourly rates of pay.**

14. **Ensure employees are paid correctly.**

Bank Reconciliations

A-C Handbook Section B.1.4 states that monthly bank reconciliations should be prepared within 30 days of the bank statement date, and be reviewed by management for appropriateness and accuracy. Both the preparer and the reviewer should sign and date the bank reconciliations.

We noted that the AEP's bank reconciliations were not prepared timely, and were not signed/dated by either the preparer or reviewer. As a result, we were unable to determine whether the bank reconciliations were reviewed for appropriateness and accuracy.

Recommendation

15. **If DCFS considers contracting with AEP in the future, AEP management ensure the Agency's bank account reconciliations are prepared timely, and are signed and dated by both the preparer and the reviewer.**